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Supreme Court of the United States

OCTOBER TERM 1951

No. 98

HAROLD S. BASS,

Petitioner,

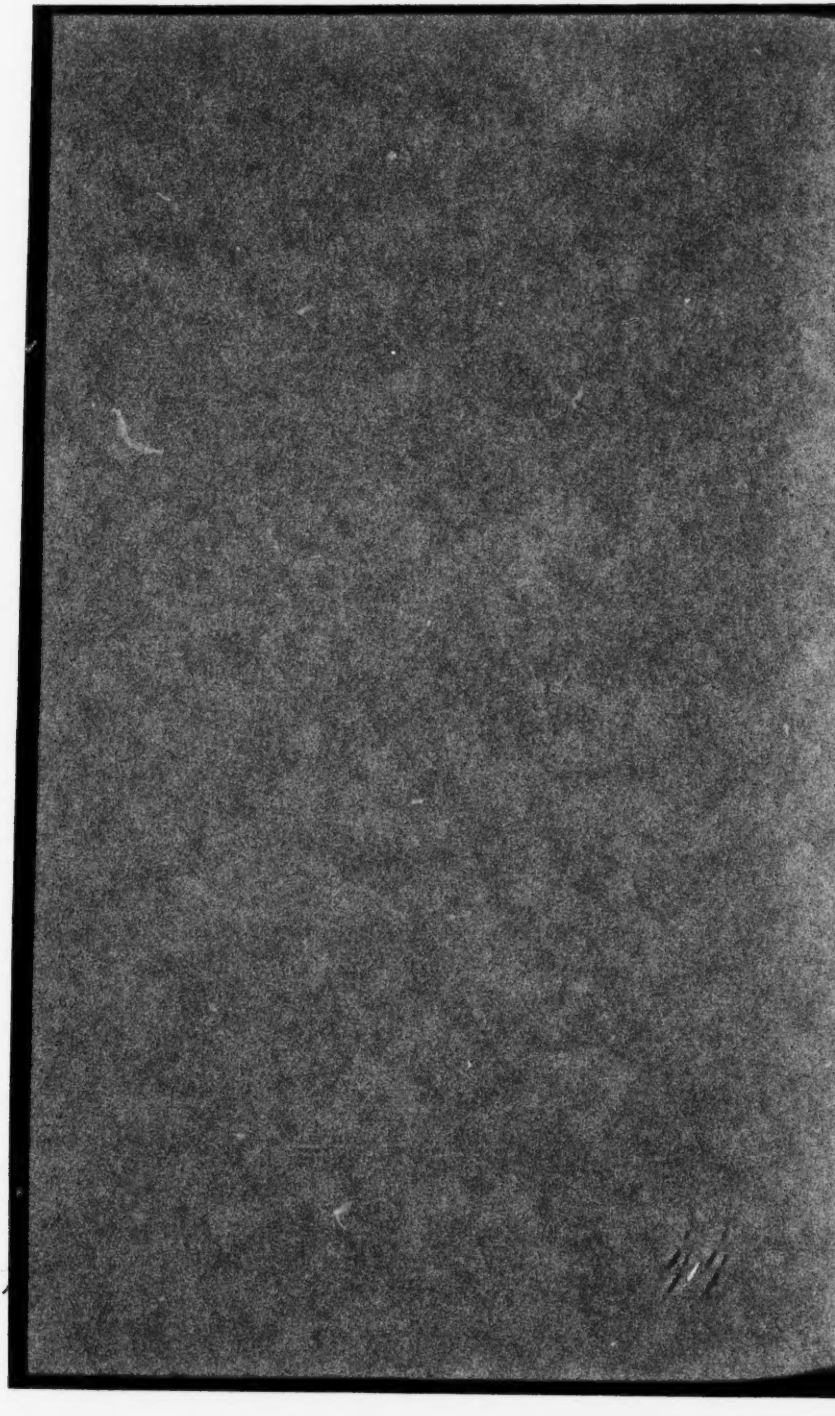
against

GUARANTY TRUST COMPANY OF NEW YORK, as Trustee under the First Consolidated Mortgage Deed of The Rio Grande Western Railway Company, dated April 1, 1899, JULIUS KLOPFER, THE CHASE NATIONAL BANK OF THE CITY OF NEW YORK, as Trustee under the Refunding and Improvement Mortgage of The Denver and Rio Grande Western Railroad Company, dated February 1, 1924, GUY RALPH FARLEIGH TRUST COMPANY, as Trustee under The Denver and Rio Grande Western Railroad Company's General Mortgage, dated February 1, 1924, WESTERN PACIFIC RAILROAD CORPORATION, GUY A. THOMPSON, as Trustee of the properties of Missouri Pacific Railroad Company, JAMES S. ALEXANDER, as Trustee, and his successors under an Agreement dated December 20, 1924, between him, The Western Pacific Railroad Corporation, The Denver and Rio Grande Western Railroad Company and Missouri Pacific Railroad Company, and THE DENVER AND RIO GRANDE WESTERN RAILROAD COMPANY,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF APPEALS OF THE STATE OF NEW YORK

JULIUS LEVY,
Attorney for Petitioner.



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Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF APPEALS OF THE STATE OF NEW YORK

Petitioner Harold S. Baird, a defendant-intervenor below, prays that a writ of certiorari issue to review the judgment of the Court of Appeals of the State of New York, entered March 9, 1951.

Opinion Below

The only opinion is the interlocutory decision of the New York Supreme Court (R. 118), reported at 194 Misc. 628, 86 N. Y. S. 2d 505. The final judgment of the Supreme Court (R. 137) and its unanimous affirmances by the Appellate Division (R. 260) and the Court of Appeals (R. 270) were without opinion.

Jurisdiction

The judgment of the Court of Appeals of New York was entered on March 9, 1951 (R. 270). The jurisdiction of this Court is invoked under 28 U. S. C. §§ 1257(3) and 2101(c).

The federal question determinative of this case was raised by the Answer (R. 77, 99) to the Complaint. The New York Supreme Court held that it "presents the principal question for decision herein" (R. 121).* As will be shown, the state courts necessarily passed upon the question in their decisions of this case.

Statute Involved

The Bankruptcy Act, § 77(e), 11 U. S. C. § 205(e), provides that, in a railroad reorganization,

> "the judge shall approve the plan [of reorganization] if satisfied that: (1) It * * * is fair and equitable * * *".

The statutory requirement that reorganization plans be "fair and equitable" embodies the "rule of full or absolute

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* The other question decided by the New York Supreme Court (R. 125-6) does not concern the issues here, but involved a controversy between other parties.

priority".* The rule prescribes that "junior securities in bankruptcy or equity reorganizations may not participate in the assets until the rights of the holders of senior securities are satisfied in full"; *Otis & Co.* v. *S. E. C.*, 323 U. S. 624, 633 (1945).

Summary of the Controversy

This case is an aftermath of the decisions of this Court (by Mr. Justice Reed) in the reorganization of the Denver Railroad: *R. F. C.* v. *Denver etc. Co.*, 328 U. S. 495 (1946); *Insurance Group Committee* v. *Denver etc. Co.*, 329 U. S. 607 (1947) (the "First" and "Second Denver cases" hereinafter).

Under the Denver's reorganization plan, both senior and junior lienors were permitted to participate in the assets. Applying the full priority rule, the bankruptcy courts adjudicated that, in view of the participation of junior claimants, the seniors were entitled to payment in full; and they further adjudicated that the new securities awarded to the seniors in the reorganization constituted such payment in full.

Despite this adjudication, the seniors now claim that their payment was less than full; and they have brought this foreclosure action to collect their alleged deficiency out of accommodation collateral pledged with them by third parties. Petitioner, a bondholder representing a junior lien on the collateral, contends that the seniors' deficiency claim is barred by the adjudication of full payment.

The state courts sustained the claim of the seniors on the ground that, despite the adjudication of full payment, they were paid only "fictionally or constructively" (R. 123).

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* *Case* v. *Los Angeles Lumber Products Co.*, 308 U. S. 106, 115, 117 (1939).

The Question Presented

The question presented is:

> Whether the full payment to senior creditors required by the absolute priority rule is a mere legal fiction so that, notwithstanding an adjudication of such payment by the bankruptcy courts, the senior creditors may subsequently claim that their payment was less than full and may seek additional payment out of accommodation collateral pledged with them by third parties.

The state courts answered the question in the affirmative. In this, we submit, they erred.

Statement

1. *The Denver reorganization.* On November 1, 1935 the Denver & Rio Grande Western Railroad Co. ("Denver") went into reorganization under § 77 of the Bankruptcy Act (R. 211). Of its six mortgage bond issues then outstanding, the three here involved were, in the order of their priority, the Consolidated Mortgage (represented by plaintiff Guaranty Trust Co.), the Refunding and Improvement Mortgage (represented by defendant Chase National Bank), and the General Mortgage (represented by defendant City Bank Farmers Trust Co.). The lien of the General Mortgage was the most junior of all six (*Denver etc. Reorganization,* 233 I. C. C. 515, 523, 524 [1939]).*

Petitioner likewise represents the bonds underlying the General Mortgage, of which he owns more than $2,000,000 face value (R. 2-3, 138).

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* This and the other reports of the Interstate Commerce Commission dealing with the Denver reorganization are part of Exhibit 9 herein which, by stipulation (R. 247), was not printed in the record, but may be quoted from.

In the reorganization proceedings, the Interstate Commerce Commission held extensive valuation hearings. In its final report, *In re Denver etc. Co.*, 254 I. C. C. 349, 356, 380 (1943), the Commission concluded that the properties of the Denver were worth $155,173,127. Since the senior claims aggregated $150,818,311, the balance of $ 4,354,816 was available for the most junior General Mortgage (in partial payment of its $43,548,155 claim).

Accordingly, the Commission's plan of reorganization fixed the Denver's new capitalization at $155,173,127; it awarded to the senior claimants, including the Consolidateds and Refundings, new securities (bonds and stocks) of a face value precisely equal to their respective claims, aggregating $150,818,311; and it awarded the balance of the new capitalization, $4,354,816 par value of new common stock, to the Generals (254 I. C. C., at 380, 385 et seq.).

After approval and confirmation by the District Court, this reorganization plan was twice reviewed and affirmed by this Court in the "First" and "Second Denver cases", *supra*. The plan was consummated in April, 1947 (R. 31, 81, 119).

2. *The adjudication of full payment.* In formulating and reviewing the plan, the parties, the Commission and the Courts were acutely aware of the requirements of the absolute priority rule.

The senior mortgagees, including the Consolidateds and the Refundings, vigorously urged that "the absolute priority rule" established "the private right of the Senior Creditors to be made whole before the General Mortgage Bonds can have any substantial participation" (Ex. E, p. 69).*

* Exhibit E is the senior mortgagees' brief of February 2, 1946, in this Court. By stipulation (R. 247), this exhibit was not printed in the record, but may be quoted from.

The Commission cited this Court's decision in the *Milwaukee* case * which requires that senior creditors be "made whole" before juniors get anything; the Commission recognized the necessity of satisfying this requirement in the Denver reorganization, "since the plan permits participation by interests wholly or partly junior to each of five of the debtor's mortgages"; and it made detailed findings that the new securities awarded to each of these five senior mortgages, including the Consolidateds and the Refundings, "adequately compensated" them for their claims (254 I.C.C., at 360-366).

The District Court, in approving the plan, likewise affirmed the creditors' right to "absolute priority", citing the *Los Angeles Lumber* case, *supra,* and others (Ex. 9, pp. 191, 195).† It adopted the Commission's finding that the compensation flowing to the senior mortgages was adequate in the light of the priority rule; and it flatly concluded that "The Plan is fair and equitable" (Ex. 9, pp. 207-8).

This Court, in reviewing the plan, held that, under the absolute priority rule, "junior claims can receive nothing until the senior claims receive securities of a worth or value equal to their indebtedness" (*First Denver* case, 328 U. S., at 517). This Court further held that "The Generals are definitely junior" (*ibid.*). It then approved the Commission's "carefully stated * * * reasons for concluding that the compensation 'flowing under the plan to the various classes of bondholders for the rights surrendered by them' was adequate in the light of the full priority rule" (*ibid.*). It repeated specifically that the Consolidateds "are entitled to be paid in full in new securities" (328 U. S., at 531, fn. 33). And, finally, it "held the priority rule was satisfied

* *Group of Institutional Investors* v. *Chicago, Milwaukee etc. Co.*, 318 U. S. 523, 566 (1943).

† By stipulation (R. 247), Exhibit 9 which sets forth the District Court's opinion and order of October 25, 1943, was not printed in the record, but may be quoted from.

by this type of allocation [of new securities]" (*Second Denver* case, 329 U. S., at 617).*

This Court, the District Court and the Commission thus adjudicated that the new securities awarded to the Consolidateds and the Refundings paid them in full.

In the face of these adjudications, plaintiff, as the indenture trustee for the Consolidateds, nevertheless brought the present action to collect a claimed deficiency. The action grows out of these facts:

3. *The accommodation collateral.* The Consolidateds, the Refundings and the Generals were secured not only by mortgages on the properties of the Denver, but also, in the same order of priority, by the pledge of 100,000 shares of stock of the Utah Fuel Company, a New Jersey corporation (R. 118). The Utah Fuel stock, however, was not property of the Denver; it belonged to two other railroad companies and was thus "accommodation collateral" (R. 118, 120). Since the jurisdiction of the reorganization courts was confined to "the debtor and *its* property",† the reorganization of the Denver could not, and did not purport to, affect or impair the existing liens on the Utah Fuel stock (R. 120).

Accordingly, this Court held that the Denver reorganization plan must be read as leaving the disposition of the Utah Fuel stock "to an independent suit in which there is jurisdiction over the proper parties" (*First Denver* case, 328 U. S., at 531, fn. 33).‡ The present action is this independent suit.

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* The Consolidateds now contend that the priority rule was not applied to them in the reorganization because theirs was only a divisional lien, whereas the Refunding and the General Mortgages covered the entire Denver system. But that contention is refuted by this Court's holdings that "The Generals are definitely junior", and that the Consolidateds "are entitled to be paid in full in new securities" (*supra*).

† Bankruptcy Act, § 77(a), 11 U. S. C., § 205(a).

‡ The Consolidateds now contend that Section K of the plan (254 I. C. C., at 398-9) awarded Utah Fuel to them. But this Court ruled, "We do not so read the plan" (328 U. S., at 529). And, obviously, this "independent suit" would be unnecessary if the plan had made an outright award of Utah Fuel to the Consolidateds.

Although this Court, because of its lack of jurisdiction over the accommodation collateral, did not determine the fate of that collateral, it strongly intimated that the seniors may well be barred from any right to Utah Fuel (*First Denver* case, 328 U. S., at 531, footnote 33):

> "There is a certain illogic in the position of First Consolidated bonds in asserting any rights in the collateral at all. If, as they concede and we now hold, they are entitled to be paid in full in new securities without regard to the collateral, it may be that they have been fully paid by the new securities given them since they do not complain of their treatment under the plan. Since they are entitled only to full payment it would then seem to follow that they have no rights against the collateral. We should not be taken as deciding this question, however, since we leave it to an independent suit in which there is jurisdiction over the proper parties."

4. *The proceedings in this action.* After the conclusion of the Denver reorganization and the issuance of its new securities, plaintiff brought this action to foreclose its alleged first lien on Utah Fuel (R. 23-63). The indenture trustees for the Refundings (Chase National Bank) and for the Generals (City Bank Farmers Trust Company), as the junior lienors, were joined as defendants; and petitioner was permitted to intervene as an additional representative of the Generals (R. 138).

The basis of plaintiff's claim was that the quoted market prices of the newly issued Denver securities were less than their face values which had been the Commission's basis for allocating the new securities. Plaintiff alleged, therefore, that the Consolidateds had sustained a deficiency (R. 34); and Chase National Bank made a similar claim on behalf of the Refundings (R. 69-70).

The Answer of City Bank (R. 77), which petitioner adopted as his own (R. 138), alleged that the adjudication of full payment to the seniors precluded them from any right to the proceeds of Utah Fuel, which should be applied

solely toward the admitted deficiency of the Generals (R. 99).

The New York Supreme Court rejected this defense on the theory that, despite the bankruptcy courts' adjudication of full payment under the absolute priority rule, the two senior mortgages were paid only "fictionally or constructively" (R. 123). The final judgment (R. 137) found, on the basis of a referee's report (R. 146), that the market prices of the new Denver securities, at the time they were issued, were substantially below par (R. 148-9); and it concluded that the Consolidateds and the Refundings had sustained large deficiencies, more than $15,000,000 each (R. 149, 150), which must be paid out of Utah Fuel, except that the Consolidateds' lien on Utah Fuel was limited by contract to a maximum of $6,000,000 (R. 120).

Pursuant to this judgment, Utah Fuel was sold at public auction for $6,800,000. Under the judgment, $6,000,000 thereof go to the Consolidateds, the remaining $800,000 to the Refundings, and nothing is left for the admitted deficiency of the Generals (R. 163-5).

Petitioner appealed to the Appellate Division and, pursuant to leave granted (R. 265), to the Court of Appeals (R. 9, 257). Upon the appeals petitioner urged in his briefs that the bankruptcy courts' adjudication of full payment barred the seniors from any right to additional payment out of Utah Fuel. The state courts' judgments of affirmance necessarily passed upon and rejected this contention.

Reasons for Granting the Writ

1. The "rule of full or absolute priority" has become a cornerstone of our law of bankruptcy reorganization. In a long line of decisions, this Court has evolved the mandate that senior claimants "are entitled to be paid in full",* must

* *First Denver* case, 328 U. S., at 531, fn. 33.

be "satisfied in full",* or must be "made whole",† before juniors get anything. This rule was "held satisfied" in the Denver reorganization (329 U. S., at 617); and that adjudication is binding here.‡

Nor can the conclusive effect of the adjudication of full payment be questioned because payment was made in new securities of the Denver rather than in cash. Payment in new securities is the equivalent of payment in cash. This Court held in the *First Denver* case, 328 U. S., at 517, that "junior claims can receive nothing until the senior claims receive securities of a worth or value equal to their indebtedness". It made a like holding in *Ecker* v. *Western Pacific R. Corp.*, 318 U. S. 448, 483 (1943). And it reiterated most recently in the *Central-Illinois* case, 338 U. S., at 143, that "the standard of compensation to be accorded security holders does not depend upon whether their security interests are to be retired by exchanging them for new securities in a continuing enterprise or by payment in cash".¶

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* *Otis* case, *supra*, 323 U. S., at 633; *S. E. C.* v. *Central-Illinois S. Corp.*, 338 U. S. 96, 151 (1949).

† *Consolidated Rock Products Co.* v. *DuBois*, 312 U. S. 510, 521, 528 (1941); *Milwaukee* case, *supra*, 318 U. S., at 566, 569; *First Denver* case, 328 U. S., at 530.

‡ This is so, in the first place, because the Consolidateds, the Refundings and the Generals—the only remaining claimants to the Utah Fuel proceeds—were represented in the bankruptcy proceedings by their respective indenture trustees. Secondly, an adjudication of full payment, rendered between a creditor and his principal debtor, enures to the benefit of the surety; *Restatement, Security* (1941), § 139 and Illustr. (1); *U. S.* v. *American Surety Co.*, 56 F. 2d 734, 736 (C. C. A. 2, 1932); *People* v. *Metropolitan Surety Co.*, 171 App. Div. 15, 156 N. Y. S. 1027 (3d Dept., 1916); and the accommodation collateral pledged by a third party stands in a suretyship relation; *Restatement, Security* (1941), § 36 and Comment (a); *Rutherford Nat. Bank* v. *Manniello*, 240 App. Div. 506, 271 N. Y. S. 69 (1st Dept., 1934), aff'd 266 N. Y. 568, 195 N. E. 203.

¶ Accord: *In re Community Gas & Power Co.*, 168 F. 2d 740, 744 (C. C. A. 3, 1948), cert. den. 334 U. S. 846; *In re New York, N. H. & H. R. Co.*, 147 F. 2d 40, 47 (C. C. A. 2, 1945), cert. den. 325 U. S. 884.

The state courts' decision herein that the seniors were nevertheless paid only "fictionally or constructively" (R. 123), thus raises the fundamental question whether a finding of full payment under the priority rule is merely a trick of semantics, a fiction; or constitutes, as we contend, an adjudication of real and genuine full payment. The judgment below, we submit, is in direct conflict with the decisions of this Court just cited.

2. The New York Supreme Court invoked § 16 of the Bankruptcy Act, 11 U. S. C. § 34,* as supporting its decision (R. 123). But that statute is not pertinent. It merely provides that the bankruptcy discharge of a debtor does not relieve his surety; nor does it relieve accommodation collateral pledged by a third party since, in effect, it stands in a suretyship relation. Nevertheless, the creditor of a bankrupt cannot demand to be paid twice. If in the bankruptcy or reorganization the creditor receives sufficient cash or securities to pay him in full, he cannot seek additional payment out of the accommodation collateral. Here, we say, the bankruptcy courts adjudicated that the reorganization securities awarded to the Consolidateds and the Refundings paid them in full; and there is nothing in § 16 which would authorize them, in the face of this adjudication, to seek additional payment out of Utah Fuel. It is this adjudication of full payment, and not the bankruptcy discharge of the Denver, upon which we rely.

3. The question whether an adjudication of full payment in reorganization securities will preclude a creditor from proceeding against accommodation collateral has not yet been determined by this or any other Court (except by the decisions below). The three cases cited by the New

* § 16 of the Bankruptcy Act provides:

"The liability of a person who is a co-debtor with, or guarantor or in any manner a surety for, a bankrupt shall not be altered by the discharge of such bankrupt."

York Supreme Court (R. 123)* are not in point. They merely applied § 16 of the Bankruptcy Act; none of them involved an adjudication of full payment under the priority rule.

But now that the absolute priority rule has been crystallized and the problem here presented—the effect of an adjudication of full payment under the priority rule upon the liability of a surety or of accommodation collateral—has been called to the attention of the Bar, the question will recur with increasing frequency. We submit that an authoritative ruling by this Court is required in the interest of substantial justice.

4. The substantial character of the question is indicated by this Court's footnote in the *First Denver* case (*supra*, p. 8), which strongly intimated that the finding of full payment to the seniors under the priority rule was inconsistent with their claiming any interest in Utah Fuel (328 U. S., at 531, fn. 33). The courts below altogether ignored this Court's suggested answer to the question here presented.

5. The question presented is of far-reaching public importance. It involves the meaning, the effect and, indeed, the integrity of the full priority rule. If it be true—as the courts below have held—that the full payment required by the rule is no more than a fiction and a sham, the sanctity of senior liens may be violated with judicial authority; the "property of one group will be subtly appropriated to pay the claims of another while lip service is rendered the principles of priority" (*Milwaukee* case, 318 U. S., at 570); and public confidence in the integrity of the reorganization proceedings conducted by the federal courts will be undermined.

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* *In re Nine North Church Street, Inc.*, 82 F. 2d 186 (C. C. A. 2, 1936); *Matter of Western Pac. R. Co.* (D. C., N. D. Cal., 1944, not reported), aff'd sub nom. *Railroad Credit Corp.* v. *Ecker*, 153 F. 2d 418 (C. C. A. 9, 1945); *Union Trust Co. of Rochester* v. *Willsea*, 275 N. Y. 164, 9 N. E. 2d 820 (1937).

CONCLUSION

For the reasons stated, this petition for a writ of certiorari should be granted.

Respectfully submitted,

JULIUS LEVY,
Attorney for Petitioner.

Dated: June, 1951.